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Over-the-Counter Derivatives: A New Era of Financial Regulation

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ABSTRACT

On July 21, 2010, President Barack H. Obama signed into law financial reform legislation titled the "Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010," also known as the "Dodd-Frank Act of 2010," (the "Dodd-Frank Act").[1] *After almost two years of intensely contentious legislative process, the U.S. Congress passed this new legislation in response to the financial crisis of 2008.*[2] *The Dodd-Frank Act is the most sweeping legislation affecting the nation's financial regulations since the Depression-era laws and is intended to restore confidence in U.S. financial markets and stimulate growth in the economy.*[3] *The new law puts U.S. banks and financial markets under tighter government control by expanding the regulatory reach of the major federal agencies.*[4] *It also sets new international standards for transparency in the financial markets and lays the foundation to build a stronger global financial infrastructure.*[5] *Of the sixteen distinct Titles of the Dodd-Frank Act on a variety of topics, this paper will provide analysis and critique of Title VII of the Dodd-Frank Act. Title VII is referred to as the Wall Street Transparency and Accountability Act of 2010 (referred to herein as the "the Act"), and provides a comprehensive framework for the regulation of OTC derivatives.*[6] *The*

* Associate Executive Director and Research Fellow at the SMU Institute of International Banking and Finance. Portions of this article are related to Ms. Sharma's ongoing research on derivatives. Special thanks to Professor Joseph J. Norton of SMU Dedman School of Law for helpful comments on earlier drafts of this article. At the time of writing this article, December 31, 2010, the Commodity Futures Trading Commission (CFTC), and Securities and Exchange Commission (SEC) are busy formulating comprehensive regulations as to Title VII.

1. *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted Into Law on July 21, 2010*, DAVIS POLK & WARDWELL LLP, i (2010), http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf.
2. V. Gerard Comizio, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Impact on Industrial Loan Banks*, CLIENT ALERT (Paul Hastings), (July 2010), http://www.paulhastings.com/assets/publications/1666.pdf.
3. *Id.*; H.R. 4173, 111th Cong. (2009), *available at* http://docs.house.gov/rules/finserv/111_hr_finsrv.pdf.
4. Comizio, *supra* note 2, at 101.
5. *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted Into Law on July 21, 2010*, *supra* note 1.
6. *The Wall Street Transparency and Accountability Act of 2010*, CLIENT PUBLICATION (Shearman & Sterling LLP), (Apr. 23, 2010), http://www.shearman.com/files/Publication/212cd5f0-44fb-45c9-9f97-51ccde55cb59/Presentation/PublicationAt-

goal of Title VII is to bring transparency and accountability to the derivatives market by mandating centralized clearing of OTC derivatives and their trading on or through designated contract markets, national securities exchanges, or swap execution facilities.[7] *Needless to say, the provisions of the Act will change the style of derivatives trading in the United States forever.*[8] *With New York being the major financial center in the Western hemisphere, the Americas will not be able to escape the impact of the new law, as the requirements of the Act will also apply to foreign entities dealing with the U.S. market participants or executing or clearing their swap transactions through a U.S. facility.*[9] *Hence, a serious consideration of the provisions of Title VII is critical to fully comprehend its implications. Though at this point it is hard to predict the full scope of the Act, there is no doubt that the effects of the reform process will be profound. After examining the role of derivatives in the financial crisis and a detailed analysis of the aforementioned and other key provisions of Title VII, the paper concludes that the transparency in the derivatives markets that will result from the use of clearinghouses, exchange trading, and public reporting of trades, will make the U.S. financial markets stronger than ever.*

I. INTRODUCTION

AS the U.S. economy experienced the worst economic nightmare since the Great Depression of the 1930s, derivatives[10] were targeted for increasing systemic risk[11] in the financial system.[12] Credit Default Swaps (CDS), a type of the over-the-counter derivative (OTC derivative), was at the forefront, and was blamed for being the lead financial product that "contributed to the overall tightening in the credit markets following the bankruptcy of Lehman Brothers and the near-collapse of American Insurance Group (AIG), which was a major CDS

tachment/d5252b86-f380-409b-b992-66aa48aba1d2/AM-042310-Wall_Street_Transparency.pdf.

7. *Id.*
8. *See id.*
9. *Id.*
10. Derivatives include exchange-traded and over-the-counter (OTC) contracts. Kristina Zucchi, *Derivatives 101*, INVESTOPEDIA.COM, http://www.investopedia.com/articles/optioninvestor/10/derivatives-101.asp (last visited Jan. 16, 2011). Standardized derivatives are typically traded on exchanges which publicly display prices and customized derivatives products are traded off-exchange or over-the-counter where prices remain private. *Id.*
11. Systemic risk is the risk that failure of a firm or disruptions in a market will extend to other firms or in other market segments and destabilize the financial system as whole. Systematic Risk, INVESTOPEDIA.COM, http://www.investopedia.com/terms/s/systematicrisk.asp (last visited Jan. 16, 2011).
12. *See generally* Robert E. Litan, *The Derivatives Dealer's Club and Derivatives Markets Reform: A Guide for Policy Makers, Citizens and Other Interested Parties*, BROOKINGS INITIATIVE ON BUS. & PUB. POL'Y, (Apr. 7, 2010), http://www.brookings.edu/~/media/Files/rc/papers/2010/0407_derivatives_litan/0407_derivatives_litan.pdf.

seller."[13] The call for greater transparency and reform of the derivatives market sparked the debate for comprehensive supervision and regulation of the OTC derivatives markets.[14] Responding to the call, the Obama Administration released its proposal in June 2009.[15] Following the Administration's Proposal, the 111th Congress considered several legislative proposals to reform the regulation of financial markets and financial institutions.[16] The goal for the new financial regulatory reform legislation was, among other things, to bring order and stability to the U.S. financial system.[17] For the derivatives world, it meant sweeping changes to the OTC derivatives market and industry.[18] The process for reform of the financial system that began in the summer of 2008 culminated on July 21, 2010, with the enactment of the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (the "Dodd-Frank Act").[19] Title VII of the Dodd-Frank Act, entitled "Wall Street Transparency and Accountability Act of 2010," (the "Act"), deals with the regulation of derivatives market and industry.[20] Under the new regime, the world of OTC derivatives has

13. Orice M. Williams, *Systemic Risk: Regulatory Oversight and Recent Initiatives to Address Risk Posed by Credit Default Swaps*, GAO-09-397T 2009, U.S. GOV'T ACCOUNTABILITY OFFICE, (Mar. 5, 2009), http://www.gao.gov/new.items/d09397t.pdf.
14. *See Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*, U.S. Dep't of the Treasury, 2 (June 17, 2009), http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.
15. *See generally id.*
16. *See generally* BAIRD WEBEL ET AL., FINANCIAL REGULATORY REFORM AND THE 111TH CONGRESS, Congressional Research Service R40975 (2010), *available at* http://assets.opencrs.com/rpts/R40975_20100331.pdf.
17. Comizio, *supra* note 2, at 101.
18. *See The Wall Street Transparency and Accountability Act of 2010*, *supra* note 6, at 1.
19. The new legislation is a compromise crafted from measures passed separately by the House and Senate under the Wall Street Reform and Consumer Protection Act of 2009, (House bill, H.R. 4173), and the Restoring Financial Stability Act of 2010, (Senate bill, S. 3217), respectively. The House of Representatives passed H.R. 4173 on December 11, 2009, by a vote of 223-202. The Senate considered S. 3217 through April and May 2010. On May 20, 2010, the Senate finished the amendment process to S. 3217, substituted this bill as amended into H.R. 4317, and passed the Senate version of H.R. 4173 by a vote of 59-39. To reconcile differences between the two bills passed by the House and Senate, a Conference Committee was appointed which convened its first meeting on June 10, 2010. The Conference Committee presented its report on the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was sent to both houses of Congress for further consideration. The House gave its approval to the report on June 30, 2010, and the Senate approved it on July 15, 2010. The approved bill was sent to the White House for enactment and President Obama signed the Dodd-Frank Act into law on July 21, 2010. *See Bill Summary & Status 111th Congress (2009-2010) H.R.4173*, THOMAS (Library of Cong.), http://thomas.loc.gov/cgi-bin/bdquery/z?d111:H.R.4173: (last visited Feb. 9, 2011); Dodd-Frank Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified at 15 U.S.C. 78a).
20. *See generally* William F. Kroener III, *Dodd-Frank Financial Reform and Its Impact on the Banking Industry: Derivates Reforms ALI-ABA Course of Study*, SULLIVAN & CROMWELL LLP, (Oct. 7, 2010), http://files.ali-aba.org/thumbs/datastorage/skoobesruoc/pdf/CS038_chapter_07_thumb.pdf.

been divided into "swaps,"[21] "security-based swaps,"[22] and "mixed swaps."[23] The Commodity Futures Trading Commission (CFTC), and Securities and Exchange Commission (SEC) have been given regulatory authority to regulate "swaps" and "security-based swaps," respectively.[24] "Mixed swaps" will be regulated by both of the Commissions.[25] The two Commissions have also been assigned the task of extensive rulemaking for the implementation of the provisions of the Act.[26] Additionally, they will also be conducting a number of studies to assess the impact of certain regulations and to bring about international harmonization of derivatives markets.[27] It is important to note that the Act allows an over-the-counter market in non-standardized swaps to continue.[28]

The Dodd-Frank Act has significance not just for U.S. entities, but also for non-U.S. entities, given the extraterritorial reach of its provisions.[29] Because of the importance of New York as the major financial center in the Western hemisphere, a large number of entities from this side of the hemisphere participate in the U.S. financial markets. Hence, it is critical that they understand the implication of the new law on their businesses. Title VII of the Dodd-Frank Act will have a substantial impact on non-U.S. entities that engage in OTC derivatives transactions in the U.S. derivatives markets.[30] Under § 715 of the Act, the CFTC and SEC, in consultation with the Treasury, have the authority to prohibit a non-resident

21. The Act defines "swap" very broadly as any agreement, contract, or transaction that is an option for the purchase or sale, or is based on the value, of an underlying financial or economic interest or property, or that provides for any purchase, sale, payment, or delivery that is dependent on the occurrence, non-occurrence, or the extent of the occurrence of an event associated with a potential financial, economic, or commercial consequence. Dodd-Frank Act § 721 The definition of "swap" includes interest rate, currency, foreign exchange, credit, equity, commodity, weather, energy, metal, agricultural, and index swaps. *Id.* Excluded from the definition are: "security-based swaps," exchange-traded futures, contracts for the sale of commodities for future delivery (or options thereon), physically settled forwards (and options thereon), and exchange-traded options on currencies and certain securities contracts. *Id.*
22. A security-based swap is a "swap" based on a narrow-based security index (including an interest therein or on the value thereof), a single security or loan (including an interest therein or on the value thereof), or the occurrence, nonoccurrence, or the extent of the occurrence of an event relating to a single issuer or narrow group of issuers in a narrow-based security-index, provided that such event directly affects the financials of the issuer. Options, forwards, and credit default swaps referencing corporate bonds and loans are included. *Id.*
23. A "mixed swap" has the characteristics of both "swap" and "security-based swap," such as a total return swap on a single security that also incorporates an FX hedge. The CFTC and SEC, in consultation with the Federal Reserve, will have joint rulemaking authority over mixed swaps. *Id.*
24. *The Wall Street Transparency and Accountability Act of 2010, supra* note 6.
25. Dodd-Frank Act § 712(a)(8).
26. *Id.* § 712(d)(2).
27. *Id.* §§ 712(f)(2), 752.
28. *Reform of the Swaps Market Under the Dodd-Frank Act Cravath*, SWAINE & MOORE LLP, (2010), http://www.cravath.com/files/Uploads/Documents/Publications/Dodd-Frank%20(Reform%20of%20the%20Swaps%20Market).pdf.
29. Dodd-Frank Act §§ 715, 722(d).
30. *Reform of the Swaps Market Under the Dodd-Frank Act Cravath, supra* note 28.

company from participating in swap activities in the United States if they determine that the regulation of swaps in the company's country undermines the stability of the U.S. financial system.[31] Further, new swap laws:

> [s]hall not apply to swap activities taking place outside the United States unless those activities (1) have a direct and significant connection with activities in, or effect on, commerce of the United States, or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent evasion of. . .the Dodd-Frank Act.[32]

Most importantly, the Act does not provide any express exemptions for non-U.S. entities from the requirements applicable to swap dealers or major swap participants.[33] Hence, depending upon the level of their activity in the United States, non-U.S. entities might be subject to regulation as swap dealers or major swap participants.[34] The implication of this for such entities is significant, thus it is in their interest to comply with the law. Additionally, until such time that the Commissions promulgate final rules, these entities should apply caution while conducting their derivatives activities to avoid potential violation of the new legislation.

This article examines derivatives, their role in the financial crisis, and discusses key provisions of the new regulatory regime established under the Act in order to evaluate its impact on the OTC derivatives and their markets. Part II provides a brief description of derivatives financial instruments and the structure of the markets in which they are traded. Part III examines the role of derivatives in the financial crisis of 2008. Part IV discusses key provisions of Title VII of the Dodd-Frank Act and their impact on the OTC derivatives market and its participants. The article, in Part V, concludes that while regulation of OTC derivatives will bring transparency and efficiency to the market, there remains work to be done to harmonize the rules on an international scale to prevent migration of business overseas. Centralized clearing, exchange trading, reporting of uncleared swaps to swap repositories, and heightened business conduct requirements will ensure success of the objectives of the legislation and make our financial markets stronger than ever.

II. DERIVATIVES AND THEIR MARKET STRUCTURE

A. Derivatives Generally

Derivatives, such as futures, options, and swaps, are financial instruments whose value is based on or derived from other assets or variables.[35] The underlying asset may be anything from stock and bonds, to commodities, interest rates, currency rates, or an index of a leading stock mar-

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31. Dodd-Frank Act § 715.
32. *Id.* § 722(d).
33. *See* Kroener, *supra* note 20.
34. *See id.*
35. *See* Zucchi, *supra* note 10.

ket.[36] Hence, these contracts are of no value by themselves, but, "rather, receive their value from movements in interest rates, the outcome of specific events, or the price of underlying assets like debt or equities."[37] Derivatives contracts have also been defined as "a form of price guarantee: an agreement between a future buyer and a future seller for something at some designated point in time."[38] An interesting aspect of derivatives is that although they are primarily used as invaluable tools of risk-management, they are also used for speculation, i.e. placing bets on the value of the underlying asset based on the investors' assessment of the market-movement, without ever owning tangible assets in that market.[39]

Derivatives transactions "allow market participants, including commodity producers, processers, and end-users, as well as corporations, banks and governmental entities, to manage financial risks caused by fluctuating interest rates, currencies, commodity prices and securities prices."[40] To manage their risks effectively and efficiently, market participants use standard and customized derivatives contracts. Standardized derivatives contracts are liquid contracts that are traded on exchanges.[41] Futures and Options are good examples of the exchange-traded financial derivatives, however, the more popular derivatives are the ones that are not traded on an exchange, but those traded off the exchange, known as "over-the-counter" (OTC) derivatives.[42] These OTC derivatives contracts are customized contracts that are tailored to the specific needs of the counterparties, and include negotiated terms, such as amounts, payment timing, and interest or currency rates.[43] Because OTC contracts are customized and tailored to meet the requirement of the trading parties, liquidity in the OTC markets can be low considering the costs involved in finding trading partners willing to take the other side of a desired transaction.[44] Additionally, it is extremely difficult to exit positions in the over-the-counter contracts before the prescribed termination date.[45] But, the customized aspect of OTC contracts is one of the reasons for its popularity, for it allows users achieve their precise risk-management needs through hedging, thereby facilitating innovation and variation in the products and making OTC derivatives valuable to business enti-

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36. *See id.*
37. Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 40 (2009).
38. John T. Lynch, *Credit Derivatives: Industry Initiative Supplants Need for Direct Regulatory Intervention-A Model for the Future of U.S. Regulation?*, 55 BUFF. L. REV. 1371, 1373 (2008).
39. *Id.*
40. Letter from Robert G. Pickel, CEO, Int'l Swaps & Derivatives Ass'n, to David Stawick, Sec'y, Commodity Futures & Trading Comm'n 2 (June 16, 2009), *available at* http://www.isda.org/speeches/pdf/ISDA-Comment-Letter-HedgeExemp.pdf.
41. *See* Zucchi, *supra* note 10.
42. *Id.*
43. *Id.*
44. ROBERT W. KOLB & JAMES A. OVERDAHL, FINANCIAL DERIVATIVES 17 (3d. ed. 2003).
45. *Id.*

ties.[46] The other reason for their popularity is that reporting, standardization and margin requirements that apply to exchange-traded derivatives, do not apply to them.[47] As a result, OTC derivatives are considered cost-effective and the least burdensome, and thus are highly attractive to the parties involved. The OTC derivatives market consists of many variations on the basic derivative contracts of forwards, options, and swaps and "is divided into five major categories: foreign currency exchange contracts, interest rate contracts, equity-linked contracts, commodity contracts, and credit derivatives," of which credit default swaps is the most popular product and is the one that brought the spotlight on derivatives during the recent financial crisis.[48]

Dealers and End Users make OTC derivatives markets.[49] Dealers—usually large banks, securities firms, insurance companies, or their affiliates—"are intermediaries; they act as principals who take sides in transactions and earn. . .spreads if and when they find others to take the opposite sides."[50] A dealer's basic role is to facilitate the transaction in exchange for financial gain in the form of a fee for executing the transaction.[51] Firms that use derivatives to manage (hedge) their financial risks or to speculate are called end users, as they are the "final buyers and sellers of risk."[52] Sophisticated investors, such as institutional investors, government entities, corporate and hedge funds, are also end users of derivatives that

> [h]old large pools of intangible financial assets (loans, bonds, shares) whose value they wish to protect, in the same way that the rest of the world protects their buildings, their houses, their manufactures, their oil, their other tangible possessions, and also hope to make a profit out of them.[53]

With the help of derivatives, the end users are able to protect the value of their assets and also make profit out o f them.

B. Market Structure of Financial Derivatives

Derivatives are traded in two kinds of markets: exchanges and OTC markets.[54] Exchanges are centralized markets that are subject to regulation by a federal agency, such as the CFTC for futures contracts or the

46. *Id.*
47. *Id.*
48. *See* Lynch, *supra* note 38, at 1376.
49. Norman M. Feder, *Deconstructing Over-The-Counter Derivatives*, 2002 Colum. Bus. L. Rev. 677, 717 (2002).
50. *Id.*
51. Thomas C. Singher, *Regulating Derivatives: Does Transnational Regulatory Cooperation Offer a Viable Alternative to Congressional Action?* 18 Fordham Int'l L.J. 1397, 1405 (1995).
52. Feder, *supra* note 49, at 717.
53. Philip R. Wood, Set-off & Netting, Derivatives, Clearing Systems, 199 (2nd ed. 2007).
54. *See* Zucchi, *supra* note 10.

SEC for stock options.[55] As a centralized facility, exchanges play a critical role in consolidating the bid (buy) and offer (sell) quotes and making it available to all market participants so that they can buy as low or sell as high as anyone else.[56] OTC markets, on the other hand, are for privately negotiated bilateral contracts between the buyer and seller, which are not traded on any exchange; hence, these markets are not regulated by any agency.[57] Although participants in the OTC markets, such as banks or bank holding company subsidiaries, are subject to regulation; state and federal bank regulators regulate banks and the Federal Reserve regulates bank holding companies.[58] The SEC oversees a derivatives dealer who is also a securities dealer.[59] Hence, limited regulation in the OTC derivatives markets along with the benefits that the OTC products offer, resulted in the phenomenal growth of these markets in the past two decades. Today, these markets are central to the trading of derivatives; treasury bills and bonds, foreign exchange, corporate bonds, and common stocks all trade over-the-counter.[60]

In derivatives markets, billions of contracts change hands making it extremely hard to assess the creditworthiness of a counterparty.[61] As a result, such contracts contain significant potential credit risk. Derivatives exchanges, such as the Chicago Mercantile Exchange (CME), the Chicago Board of Trade (CBOT), or the Chicago Board of Exchange (CBOE), deal with the issue of credit risk by employing a clearinghouse, which clears and handles post trade processing.[62] The presence of a clearinghouse in the transaction ensures payment and settlement to both the parties.[63] Typically, the transactions require posting of collateral or margin by counterparties to help the clearinghouse manage the credit risk.[64] The margin accounts of the counterparties are marked-to-market on a daily basis and the clearinghouse collects additional margin from traders for any price movement.[65] Furthermore, clearing members are also subject to capital requirements of the clearinghouse.[66] The purpose of these requirements is to protect a counterparty from potential losses

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55. *Preliminary Staff Report: Overview on Derivatives*, FIN. CRISIS INQUIRY COMM'N, 7 (2010), http://www.fcic.gov/reports/pdfs/2010-0630-psr-derivative-overview.pdf.
56. *Id.*
57. *Id.* at 8.
58. *See* Lynch, *supra* note 38, at 1380.
59. *See generally id.*
60. *See* René Stulz, Everett D. Reese Chair of Banking & Monetary Econ., Fisher Coll. of Bus., Ohio State Univ., Hearing Before the H. Comm. on Fin. Serv., 111th Cong.: Over-the-Counter Derivatives Markets Act of 2009 (2009), *available at* http://fisher.osu.edu/fin/faculty/stulz/Written%20Testimony%20of%20Rene%20M%20%20Stulz%20Revised.pdf [hereinafter *Testimony René Stulz*].
61. *See* Lynch, *supra* note 38, at 1380.
62. *Preliminary Staff Report: Overview on Derivatives*, *supra* note 55, at 8.
63. *Id.*
64. *Id.*
65. RENA S. MILLER, KEY ISSUES IN DERIVATIVE REFORM, Congressional Research Service R40965, at 3 (2009).
66. *Preliminary Staff Report: Overview on Derivatives*, *supra* note 55, at 8.

that might result from the other party's nonpayment.[67] Most importantly, these requirements also prevent build up of large paper loss that could damage the clearinghouse in case of default.[68]

By contrast, "In the OTC market. . .there is a network of dealers rather than a centralized market place."[69] Firms that act as dealers stand ready to take either long or short positions, and make money on spreads and fees.[70] There is no clearinghouse to interpose itself between the dealer and the end user: "The dealer absorbs the credit risk of customer default, while the customer faces the risk of dealer default."[71] While there is no central counterparty involved in OTC transactions, OTC derivatives contracts require collateral or margin, for protection from the risk of counterparty default.[72] As long as the requirements of margin and collateral posting are fulfilled, the operations run smoothly, however, there is a potential for large uncollateralized losses to build up in the OTC market as collateral or margin requirements are not mandatory.[73] A case in point is AIG, "which wrote about $1.8 trillion worth of credit default swaps guaranteeing payment if certain mortgage-backed securities defaulted or experienced other 'credit events,'" such as bankruptcy, obligation acceleration, obligation default, failure to pay, repudiation or moratorium, and restructuring—the six credit events provided under International Swaps and Derivatives Association (ISDA) definitions.[74] Not only did AIG fail to post collateral when the credit quality of the underlying securities (or AIG's own credit ratings) deteriorated, but the firm was also able to avoid posting initial margin because of its triple-A rating.[75] AIG could sidestep the collateral and margin requirements because the structure of the OTC derivatives market allowed it. Given the size of AIG's OTC derivatives position, there was grave danger to the stability of the U.S. financial markets from the failure of the insurance giant and, fearing the domino effect of AIG's bankruptcy, "the Federal Reserve and the Treasury put tens of billions of dollars into AIG, the bulk of which went to its derivatives counterparties" and contained the spillover.[76] Although derivatives were not the main cause of the crisis, flaws in their market structure allowed for the buildup of systemic risk in the economy.

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67. *Id.*

68. MILLER, *supra* note 65, at 3.

69. *Id.*

70. "In this kind of market, one would expect the dealers to be the most solid and creditworthy financial institutions, and in fact the OTC market that has emerged is dominated by two or three dozen firms-very large institutions like JP Morgan Chase, Goldman Sachs, Citigroup, and their foreign counterparts." *Id.*

71. *Id.*

72. *Id.*

73. *Id.* at 4.

74. *Id.* ISDA's Master Agreement is a standard contract commonly used by derivatives parties to document OTC derivative transactions.

75. MILLER, *supra* note 65, at 4.

76. *Id.*

III. ROLE OF DERIVATIVES IN THE RECENT FINANCIAL CRISIS

A. The Buildup to the Financial Crisis of 2008

There was no single factor that caused the financial crisis. To understand the role played by derivatives in the crisis, it is important to comprehend the regulatory environment that contributed to the popularity of derivatives and fostered the rapid growth of their markets. Although derivatives markets in the United States date back to 1865, derivatives markets for financial instruments appeared in the 1970s.[77] The regulation of derivatives began with the Grain Futures Act of 1921 (GFA), which regulated grain futures contracts that were traded on exchanges.[78] The current federal law governing derivatives and derivatives markets is the Commodity Exchange Act (CEA), which was passed by the Congress in 1936 to prevent price manipulation, fraudulent activities of bucket shops,[79] and other trading abuses in the futures market.[80] In 1971, the Bretton Woods system (a system of fixed exchange rate between currencies) collapsed and it fuelled the growth of the derivatives industry.[81] Futures contracts on financial instruments were introduced to manage the currency risk. As futures markets evolved and were dominated by futures based on financial products, there was a change in the composition of market participants—farmers and commodity users were joined by large financial institutions and the transactions became more complex.[82] An over-the-counter market for derivatives grew rapidly in 1980s, but despite the exponential growth, there was still no legal definition of the term "futures contract"—the CEA did not define it, nor did the numerous amendments to it.[83] The lack of a definition created uncertainty for swaps and other OTC derivatives contracts that were similar to exchange-traded futures in their economic function but were privately negotiated between counterparties outside organized exchanges.[84] There was a potential legal risk that they might be considered invalid and unenforceable, as these contracts, if determined to be futures contracts, were violating the CEA's requirement that futures be traded on an organized ex-

77. *See* Don Chance, Essays in Derivatives 16 (2001) *available at* http://husky1.stmarys.ca/~gye/derivativeshistory.pdf.
78. This Act was held unconstitutional by the Supreme Court. Hill v. Wallace, 259 U.S. 44 (1922).
79. Bucket shops accept orders and sell a derivative interest in security or commodity future, "but they do not execute the orders in the. . .market." *The Commodity Exchange Act: Legal & Regulatory Issues Remain*, GAO/GGD-97-50, U.S. Gen. Accounting Office, 5 n.10 (1997) http://www.gao.gov/archive/1997/gg97050.pdf [hereinafter GAO Report CEA]. In case of adverse price movement in the futures market against the bucket shops, "they often close their doors or file for bankruptcy protection, leaving uncollectible debts." *Id.*
80. *Id.* at 5.
81. *Preliminary Staff Report: Overview on Derivatives*, *supra* note 55, at 19.
82. GAO Report CEA, *supra* note 79, at 5.
83. *Id.*
84. *Id.*

change.[85] In 1999, the President's Working Group on Financial Markets (PWG) made recommendations to the Congress to resolve legal uncertainties concerning OTC derivatives.[86] The group's recommendation was to exclude from oversight certain bilateral transactions between sophisticated counterparties and to eliminate impediments to clearing OTC derivatives, which Congress accepted and implemented in the Commodity Futures Modernization Act of 2000 (CFMA), signed into law by President Clinton on December 21, 2000.[87] The legislative purpose for enacting the CFMA was

> [t]o promote innovation for futures and derivatives and to reduce systemic risk by enhancing legal certainty in the markets for certain futures and derivatives transactions; to reduce systemic risk and provide greater stability to markets during times of market disorder by allowing the clearing of transactions in over-the-counter derivatives through appropriately regulated clearing organizations; and to enhance the competitive position of [U.S.] financial institutions and financial markets.[88]

The CFMA removed OTC derivatives transactions from the requirements of exchange-trading and clearing under the CEA as long as the counterparties to the swaps were "eligible contract participants," *i.e.*, had in excess of $10 million in total assets.[89] As a result, OTC derivatives were exempt from the CEA's requirement for capital adequacy, clearing, reporting, and disclosure or any other requirement that would have the effect of regulating the market.[90] The reasoning behind keeping the market out of the reach of any regulation was that a vast majority of OTC transactions were between sophisticated parties who were subject to oversight by their appropriate regulators.[91] Additionally, it was felt that the self-discipline of the private counterparties would be sufficient to keep a check on the market and prevent systemic risk from building in the financial system.[92] The CFMA was successful in providing certainty to the OTC derivatives and marked the beginning of the phenomenal growth of OTC derivative markets as a result of the blanket exemptions.[93] Another interesting outcome of the new exemptions was that

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85. HAL S. SCOTT, THE GLOBAL FINANCIAL CRISIS 112 (2009).
86. *See generally Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, GAO/GGD-00-3, U.S. GEN. ACCOUNTING OFFICE, (1997), http://www.gao.gov/products/GGD-00-3. The Secretary of the Treasury chairs the working group, and other members include the chairs of CFTC, the Federal Reserve System, and the Securities and Exchange Commission. *Id.*
87. *The Commodity Futures Modernization Act of 2000*, SIMPSON THACHER & BARTLETT LLP, 1 (2001), http://www.whitehouse.gov/files/documents/cyber/Treasury%20-%20Banking%20and%20Finance%20Sector%20Profile%20and%20Goals.pdf.
88. Lynch, *supra* note 38, at 1378.
89. *Id.* at 1378-79.
90. *Id.* at 1379.
91. *Id.* at 1380.
92. *Id.*
93. The derivatives markets were transformed from simple commodity exchanges to multi-trillion dollar markets. *Id.* at 1382.

they facilitated strong interconnectedness among the financial institutions and in the following years a handful of financial institutions rose to become major dealers who controlled the trading of derivatives.[94] These financial institutions transacted heavily with each other trading OTC financial derivatives to hedge the risks from their customer trades and also to trade for their own account, and had strong interconnection as counterparties to derivatives transactions.[95]

The financial crisis exposed the interconnectedness of these OTC derivative counterparties and the potential such interconnection had for causing serious damage to the financial system through a domino effect, wherein the failure of a single counterparty could lead to the failure of all counterparties.[96]

B. THE FINANCIAL CRISIS OF 2008

The near-collapse of Bear Stearns in March 2008, followed by the bankruptcy of Lehman Brothers on September 15, 2008, and the bailout of American International Group (AIG) on September 16, 2008, put derivatives at the center of the crisis.[97] While the leading proximate causes of the financial crisis were the unsound practices of the U.S. mortgage lending industry in the early 2000s and excessive foreclosures resulting from the housing market bubble burst, OTC derivatives, particularly credit default swaps (CDS) and collateralized debt obligations (CDO), were blamed for exacerbating the condition of the financial markets.[98] CDOs are asset-backed debt securities derived from various underlying assets, such as loans and bonds.[99] CDOs derived from mortgage bonds are known as collateralized mortgage obligations (CMO) and their value depends on the value of the mortgages, which, in turn, depends on how many of them are being paid off.[100] CDOs, in general, were extremely popular as an investment product up to 2007 and their popularity stemmed from the fact that they provided high yields and were structured in a way that they could withstand adverse events.[101] Credit Default Swaps, on the other hand, are bilateral swap contracts that insure against losses to financial institutions and corporate bondholders from credit risks—that is, provide protection in case of default, bankruptcy, or credit

94. *Id.*
95. Darrell Duffie, *How Should We Regulate Derivatives Mkts?*, PEW FIN. REFORM PROJECT, (2009), http://www.pewfr.org/admin/project_reports/files/Pew_Duffie_Derivatives_Paper_FINAL-TF-Correction.pdf.
96. *Id.* at 5-6.
97. *Id.* at 5.
98. *Id.*
99. Though CDOs are derived from mortgage bonds, their being considered as derivatives or not is a matter of labeling. CDOs are not held under ISDA Master Swap Agreement. They are insured by credit default swaps (CDS). CDOs "are regulated under laws governing the issuance of debt securities." *Id.* at 5.
100. *Id.*
101. *Collateralized Debt Obligations*, N.Y. TIMES, July 21, 2010, *available at* http://topics.nytimes.com/topics/reference/timestopics/subjects/c/collateralized-debt-obligations/index.html?inline=nyt-classifier.

ratings downgrade resulting in inability of the borrower of the loan to repay the loan.[102] They are similar to insurance contracts, in which the seller of the protection promises the buyer of the protection a particular amount in case of a default, in exchange for payment of a periodic premium fee. The value of CDSs swings with the fiscal health of the transaction or asset it is written to cover.[103] During the recent housing boom in the United States, CDS sellers sold protection to CDO investors against the default of mortgage-backed securities—as long as the housing prices were appreciating and mortgage borrowing was escalating, the CDO and CDS markets were also thriving.[104] When the housing bubble deflated in 2007, the residential property prices plunged and the subprime borrowers began defaulting on their loans.[105] The mortgage defaults reduced the value of mortgage-backed securities and, as a result, holders of these securities lost their payments and their investments.[106] The CDO market was hit hard by mortgage defaults.[107] The situation in the market was further aggravated by the fact that investors were too scared to touch housing-based investments, crashing any hope to save the market by raising new capital. The CDS market, wherein CDSs were sold as protection for CDOs backed by subprime mortgages, was in no better shape either.[108] The CDS insurers came under tremendous pressure to compensate banks and other protected buyers for the loss of value in their CDO portfolios from mortgage defaults.[109] But, they were not adequately capitalized to make good on their promises and the CDO and CDS markets were completely destroyed, which, in turn, shook the foundation of prominent Wall Street firms that were heavily invested in these markets.[110]

Bear Stearns, the nation's fifth largest investment banking firm, had made significant investments in mortgage-backed securities and was heavily exposed to the subprime mortgage market.[111] Like other Wall Street firms, Bear was also actively engaged in packaging, underwriting, trading, and investing in mortgage-backed securities.[112] It also operated a significant prime brokerage business, in which it served as a counterparty intermediary for a large volume of OTC derivatives transactions.[113] With the meltdown of the subprime mortgage market, Bear

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102. Duffie, *supra* note 95, at 5.
103. Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 200 (2009).
104. *See generally* Martin Neil Bailey et al., *The Origins of the Financial Crisis*, BROOKINGS: INITIATIVE ON BUSINESS AND PUB. POL'Y, (Nov. 2008), http://www.brookings.edu/~/media/Files/rc/papers/2008/11_origins_crisis_baily_litan/11_origins_crisis_baily_litan.pdf.
105. *Id.*
106. *Id.*
107. *Id.*
108. *Id.*
109. *Id.*
110. Duffie, *supra* note 95, at 5.
111. Okamoto, *supra* note 103, at 197.
112. *Id.*
113. Prime brokerage business of an investment bank focuses on the trading activities of large professional traders like hedge funds. *Id.*

Stearns was forced to write-down losses in its trading portfolios comprised of mortgage-related securities.[114] These portfolios were used as collateral to support its access to borrowed funds.[115] Bear's lenders asked for more collateral and the firm was left with no other option other than to sell its mortgage-related assets at sharply discounted prices to meet the collateral calls.[116] The fire sale of the assets led to a further drop in their value, thus making the market nervous about Bear Stearns' financial health and generally reluctant to lend funds to the firm through the interbank market.[117] Around the same time, Bear's prime brokerage clients also withdrew their accounts from the firm, causing panic in the already nervous market and leading derivatives counterparties to start making margin calls for additional collateral to protect themselves from potential losses in the event Bear Stearns fell into bankruptcy.[118] Finally, it all resulted in creating enormous pressure on the already shrinking liquidity of the firm, causing a liquidity crunch, and Bear suffered a run on the bank.[119] In an effort to avert the firm's bankruptcy, stabilize the firm, and prevent a wider financial panic, the Federal Reserve intervened and Bear Stearns was sold off to J.P. Morgan on March 22, 2008.[120]

Lehman's story was not much different from that of Bear Stearns. Like Bear, Lehman had also made significant investments in mortgage-backed securities and was equally exposed to the subprime mortgage market.[121] Lehman was a major player in the securitization and credit derivatives markets and it "actively sought to arbitrage the securitization and credit derivatives markets by investing in securitizations and subsequently divesting itself of the associated risk by means of CDS of CDO transactions."[122] The collapse of the housing market in 2007 significantly impacted Lehman's multi-billion dollar portfolio of mortgage-related securities, and as its losses intensified, Lehman's credit ratings began to sink leading to demands for the firm to post additional collateral, which it was unable to do, thus leading it to file for bankruptcy on September 15, 2008.[123] Lehman's bankruptcy created an environment of distrust, and

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114. *Id.*
115. *Id.*
116. *Id.*
117. JAN JOB DE VRIES ROBBÉ, STRUCTURED FINANCE: ON FROM THE CREDIT CRUNCH–THE ROAD TO RECOVERY 21 (2009).
118. Okamoto, *supra* note 103, at 197.
119. *Id.*
120. *Bear Stearns to Sell Itself to JPMorgan for $2 A Share*, N.Y. TIMES, Mar. 16, 2008, http://dealbook.nytimes.com/2008/03/16/bear-stearns-races-to-a-sale-to-jpmorgan/.
121. Okamoto, *supra* note 103, at 197-98.
122. *See* ROBBÉ, *supra* note 117, at 22. But, investigation has revealed that it was not CDS that led to the firm's failure. Lehman's bankruptcy examiner's report states that the firm failed because of the poor business decisions of its management. In fact, Lehman's derivative trades, which accounted for only 3.3% of its net assets, were more carefully monitored than other asset classes. *See* Anton R. Valukas, *In re* Lehman Bros. Holdings, Examiner's Report 16-17 & 568-578, *available at* http://lehmanreport.jenner.com (last visited Apr. 15, 2010).
123. *Sept. 15, 2008 (Monday): Lehman Files for Bankruptcy; Stocks Plummet on Wall St.*, SMART MONEY, Sept. 15, 2008, http://www.smartmoney.com/investing/econ-

financial institutions that had open trading positions with Lehman became wary of lending to each other, fearing that open positions against Lehman might implicate the creditworthiness of their counterparties, leading to a credit freeze in the financial markets.[124]

Only two days after Lehman declared bankruptcy, the Federal Reserve bailed out the American International Group, Inc. (AIG), with an $85 billion revolving two-year credit facility from the Federal Reserve Bank of New York.[125] Although AIG was an insurance company rather than an investment bank, it was heavily exposed in the credit derivatives market—it sold massive amount of CDSs through its Financial Products Group, headquartered in London, without having the financial resources necessary to cover potential payments.[126] AIG "wrote about $1.8 trillion worth of credit default swaps guaranteeing payment if certain mortgage-backed securities defaulted or experienced other 'credit events.'"[127] Of this, $ 61.4 billion was written on CDOs with exposure to subprime mortgages.[128] The collapse of the subprime housing market impacted the value of the CDOs that the company wrote CDSs on and AIG was forced to write-down massive losses in its CDS portfolio: $11.2 billion in 2007, and $19.9 billion for the first nine months of 2008.[129] Additionally, AIG's credit-rating downgrade required the firm to post $14.5 billion in collateral.[130] Although AIG had assets to take care of the additional collateral requirement, there was not enough time for it to satisfy those demands promptly.[131] There was a danger that the insurance giant would collapse, and with it, potentially all the banks that had purchased protection from it. Because OTC contracts are customized contracts with limited transparency in their markets, it was unclear which banks were exposed to AIG's insolvency, and to what degree.[132] This uncertainty caused the credit markets to freeze at the peak of the crisis, thereby forcing the government to step in to control the situation and bring stability to the markets—primarily though bailouts, of which AIG received a substantial amount to pay its counterparties.[133]

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omy/september-15-2008-monday-lehman-files-for-bankruptcy-stocks-plummet-on-wall-street/.

124. *See* ROBBÉ, *supra* note 117, at 22.

125. *See generally* Justin Fox, *Why the Government Wouldn't Let AIG Fail*, TIME, Sept. 16, 2008, http://www.time.com/time/business/article/0,8599,1841699,00.html; Matthew Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 17, 2008, http://online.wsj.com/article/SB122165238916347677.html.

126. Okamoto, *supra* note 103, at 200.

127. MILLER, *supra* note 65, at 4.

128. *AIG*, 2007 ANNUAL REPORT (FORM 10-K), at 122 (Feb. 27, 2008), *available at* http://idea.sec.gov/Archives/edgar/data/5272/000095012308002280/y44393e10vk.htm.

129. *Id.*

130. Karnitschnig et al., *supra* note 125.

131. *Id.*

132. MILLER, *supra* note 65, at 4.

133. Karnitschnig et al., *supra* note 125.

The set-back to the economy because of these incidents generated increased concern about the state of the OTC markets. It was strongly felt that limited transparency of these markets and transactions therein let them grow to such enormity unchecked, which ultimately resulted in causing serious damage to the U.S. financial system.[134] Additionally, the interconnectedness of the financial institutions only aggravated the matter further as the risk of CDS and other OTC derivatives remained concentrated among a handful of such institutions. The old debates concerning the regulation of OTC derivatives took the forefront and with great vigor this time around. Finally, after two years of contentious legislative process, the Dodd-Frank Act was signed into law on July 21, 2010.[135]

IV. KEY PROVISIONS OF TITLE VII OF THE DODD-FRANK ACT

Title VII of the Dodd-Frank Act, the "Wall Street Transparency and Accountability Act," essentially alters the trading of swaps and other OTC derivatives in the United States with its repeal of the exemptions that OTC derivatives enjoyed under the provisions of the CFMA and by subjecting the OTC derivatives market to an extensive regulatory framework.[136] Unless otherwise provided, the provisions of Title VII become effective on the later of (1) July 16, 2011, which is 360 days from the enactment date of the Dodd-Frank Act, and (2) in case of provisions of the Act that require a rulemaking, sixty days after the publication of such rule or regulation implementing that provision.[137] Under the new regime, derivatives market, its participants, and trading activity will be subject to comprehensive regulation and supervision.[138] The Act provides the CFTC and SEC with the authority to regulate swaps, their dealers, and markets while maintaining the jurisdictional separation between the two agencies reached under the Shad-Johnson Accord.[139] Whereas the CFTC will have substantial regulatory authority over swaps, swap dealers, and major swap participants, the SEC will have the same authority over security-based swaps, security-based swap dealers, and major security-based swap participants.[140] It is noteworthy though that according to recent estimates, the majority of outstanding OTC derivatives will fall

134. Duffie, *supra* note 95, at 11.
135. *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted Into Law on July 21, 2010*, *supra* note 1, at i.
136. *The Wall St. Transparency & Accountability Act: Implications for Derivatives Market Participants*, CLIENT MEMORANDUM (Willkie Farr & Gallagher LLP), 1 (JULY 23, 2010), http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3437%5CThe-Wall-Street-Act.pdf.
137. *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted Into Law on July 21, 2010*, *supra* note 1, at 61.
138. *The Wall St. Transparency & Accountability Act: Implications for Derivatives Market Participants*, *supra* note 136, at 1.
139. *Id.*
140. *Id.* at 1-2

under the jurisdiction of the CFTC.[141] The CFTC, once described as a "sleepy little agency" by its then-chairwoman Mary Schapiro, post-Dodd-Frank Act, is the top cop for the U.S. derivatives market.[142] The Act further requires the aforementioned two agencies to issue in joint rules with respect to a small number of definitions for the implementation of the legislation.[143] In doing so, they are required to consult with each other and with federal banking regulators of banking institutions engaged in swap activities.[144] Hence, it is critical that the regulators cooperate with each other for the successful completion of the extensive rulemakings.

The objective of the new legislation is to bring about transparency and efficiency in the market, promote competition, reduce the potential for counterparty and systemic risk, and also tackle the issue of interconnection in the financial markets. This objective will be achieved by having a regulatory system that requires: (1) all swaps, subject to limited exceptions, be centrally cleared and traded on exchanges or comparable trading facilities; (2) swap dealers and major market participants be subjected to capital and margin requirements, and heightened business conduct requirements; and (3) public reporting of transaction and pricing data on both cleared and un-cleared swaps.[145] In this article, the focus is to discuss the key provisions of Title VII and analyze their impact on dealers and end users of swaps.

A. Regulation of Markets and Market Participants

1. *Registration of Swap dealers and Major Swap Participants*

The Act requires swap dealers, including security-based swap dealers, and major swap participants, including major security-based swap participants, to register with the CFTC or SEC, depending on if their business involves swaps or security-based swaps, not later than one year after the enactment date, i.e. July 16, 2011.[146] Upon registration, these swap dealers and MSPs will be subject to additional scrutiny and regulation—they will submit reports of their trading activity, terms and conditions of their swaps, and their financial integrity protection to the CFTC or SEC, as applicable.[147] An entity can be designated a swap dealer (or security-based swap dealer) or a major swap participant (or major security-based

141. Marc Howitz et al., *Dodd-Frank Act Aims to Fundamentally Change Trading of OTC Derivatives*, DLA Piper, Jul. 26, 2010, http://www.dlapiper.com/dodd-frank-act-aims-to-fundamentally-change-trading-of-otc-derivatives/.
142. CFTC Chairman Gary Gensler has requested Congress to increase his agency's budget by sixty-nine percent next year to $286 million. Asjylyn Loder & Matthew Leising, *Republican Victory Won't Stop New Rules, Gensler Says*, Bloomberg Businessweek, Nov. 3, 2010, http://www.businessweek.com/news/2010-11-03/republican-victory-won-t-stop-new-rules-gensler-says.html.
143. Dodd-Frank Act § 712(d).
144. *Id.*
145. *See generally* Dodd-Frank Act.
146. Dodd-Frank Act § 731 (to be codified at 7 U.S.C. 4s(b)(5)).
147. § 731 (to be codified at 7 U.S.C. 4s(j)).

swap participant) for a single type, class, or category of swap (security-based swap) or for multiple classes of swaps.[148] The Act grants authority to the Commissions to determine the form and manner of the registration process for swap dealers and major swap participants.[149] The terms "swap dealer"[150] and "security-based swap dealer"[151] are similarly defined and refer to a dealer in swaps or security-based swaps respectively. The only difference between the two definitions is substitution of "security-based swap" in place of "swap." In this article, the term "swap dealer" is used to refer to both. A swap dealer is defined as any person who:

> (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.[152]

Under this definition banks, dealers, and other financial institutions that are active in derivatives markets will be considered "swap dealers" unless (a) an insured depository institution "offers to enter into a swap with a customer in connection with originating a loan with that customer;"[153] (b) an entity buys or sells swaps "for such person's own account, either individually or in a fiduciary capacity,"[154] and not as "part of a regular business;"[155] and (c) "an entity that engages in a 'de minimis quantity'[156] of swap dealing in connection with transactions with or on behalf of its customers."[157] Like swap dealers, major swap participants will also be subjected to extensive supervision and scrutiny.[158] The terms "Major Swap Participant"[159] and "Major Security-Based Swap Participant"[160] are also similarly defined and refer to a participant in swaps or security-based swaps respectively. Again, the difference between the two terms is substitution of "security-based swap" in place of "swap." For the purpose of this article, the term "MSP" will be used to refer to both. A MSP is any entity that is not a swap dealer and that fulfills any one of the following criteria:

> It "maintains a 'substantial position' in swaps for any of the major swap categories as determined by" the CFTC or SEC, excluding "po-

148. § 721(to be codified at 7 U.S.C. 1a), 761(to be codified at 15 U.S.C. 78c(a)(71)).
149. § 731 (to be codified at 7 U.S.C. 4s(b)).
150. § 721(to be codified at 7 U.S.C. 1a).
151. § 761 (to be codified at 15 U.S.C. 78c(a)(71)).
152. § 721 (to be codified at 7 U.S.C. 1a(49)(A)).
153. *Id.* No such exception for depository institutions from the definition of "security-based swap dealer." § 761 (to be codified at 15 U.S.C. 78c(a)(71)).
154. § 721 (to be codified at 7 U.S.C. 1a(49)(C)).
155. *Id.* (to be codified at 7 U.S.C. 1a(49)(C)) (referencing end users).
156. What constitutes "de minimis quantity," will be determined through the CFTC and SEC rulemaking process.
157. Dodd-Frank Act §721 (to be codified at 7 U.S.C. 1a(49)(C)).
158. *Id.* (to be codified at 7 U.S.C. 1a(33))
159. *Id.*
160. § 761 (to be codified at 15 U.S.C. 78c(a)).

sitions held for hedging or mitigating commercial risk" and positions held by employee benefit plans for hedging or mitigating its risks;[161]
Its "outstanding swaps create 'substantial counterparty exposure' that could have serious adverse effects on the financial stability of the United States banking system or financial market"[162]; or
It "is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency," and it "maintains a substantial position in outstanding swap" transactions in CFTC or SEC determined major swap categories.[163]

The definition of MSP excludes from its purview finance subsidiaries, *i.e.* entities "whose primary business is providing financing, and uses derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures."[164] These finance subsidiaries facilitate the purchase or lease of products which are manufactured by the parent company or another subsidiary of the parent company. It is worth noting that the definition of MSP is critical for the end user exemption extended to the corporate users of derivatives under the provisions of the Act. If an entity does not fall within the criteria specified for a MSP and is not a swap dealer, it can avail the benefits of the end users exemption—in which case the entity will not be subject to clearing requirements as long as the entity engages in OTC derivatives to hedge commercial risk of its business.[165]

2. *Capital and Margin Requirements*

Swap dealers and major swap participants, pursuant to registration, will be required to satisfy minimum capital requirements, and with respect to uncleared swaps, margin requirements (initial and variation).[166] The capital and margin requirements will be determined by the CFTC or SEC for nonbank swap dealers and nonbank major swap participants.[167] For banks that are swap dealers, the appropriate federal banking regulator, in consultation with the Commissions, will establish these requirements, not later than one year after the enactment date.[168] With respect to cleared swaps, the requirements of DCO or the clearing agency, as applicable, will apply.[169] In determining the capital and margin requirements for uncleared swaps, the regulatory bodies must take into account the risks as-

161. § 721 (to be codified at 7 U.S.C. 1a(33)(A)(i)). Under the requirements of the Act, the CFTC or SEC will define the term "substantial position," which shall be at a level prudent for monitoring of such entities that are systemically important. *Id.*
162. *Id.* (to be codified at 7 U.S.C. 1a(33)(A)(ii)). The term "substantial counterparty exposure" will be addressed in the rulemaking process by the CFTC and SEC.
163. Dodd-Frank Act § 721 (to be codified at 7 U.S.C. 1a(33)(A)(iii)).
164. *Id.* (to be codified at 7 U.S.C. 1a(33)(D)).
165. *Id.*
166. § 731 (to be codified at 7 U.S.C. 4s(e)), 764 (to be codified at 15 U.S.C. 78a).
167. *Id.* (to be codified at 7 U.S.C. 4s(e)).
168. *Id.*
169. *Id.*

sociated with all swaps and other activities of the swap dealer or MSP, and not just the risks related to the types, classes, or categories of swaps that made such entity eligible to qualify as a swap dealer or MSP.[170] The prudential regulator and the Commissions also have the authority to allow the use of noncash collateral to meet margin requirements as long as it is consistent with the financial integrity of the swap markets and preserving the integrity of the U.S. financial system.[171] At this point, it will not be unreasonable to assume that the capital and margin requirements for uncleared swaps will be significantly higher than the requirements imposed in connection with cleared swaps. The intent of the legislation is to "offset the greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared," and that the requirements shall "(i) help ensure the safety and soundness of the swap dealer or major swap participant; and (ii) be appropriate for the risk associated with the non-cleared swaps held as a swap dealer or major swap participant."[172] It is worth highlighting that the higher capital and margin requirements for uncleared swaps will translate into higher cost of transaction for counterparties. The increased costs along with low liquidity for uncleared swaps might deter business entities from entering into customized bilateral transactions. Further, despite Congress's intention to exclude end users from the margin requirement, there is no express exemption for end users under the Act similar to the exemption from the clearing requirement for such end users. Unless there is clarity on the issue of exemption from margin for existing swaps or end user swaps, the situation will remain unclear.[173]

3. *Recordkeeping and Business Conduct Requirements*

The Act mandates that swap dealers and major swap participants provide reports to the CFTC or SEC, as applicable, regarding the transactions they enter into, the positions they take, and their overall financial

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170. *Id.*
171. *Id.*
172. *Id.*; *see also* § 764 (to be codified at 15 U.S.C. 78a).
173. There is no provision in the Act authorizing regulators to retroactively impose margin and capital requirements to existing swaps. But, while addressing mandatory central clearing of swaps, the Act provides that a financing affiliate, subsidiary or a wholly-owned entity of a person that qualifies for the non-financial entity exemption to the mandatory clearing requirement, will be exempt from margin requirements for the first two years after the date of enactment of the Act. Senators Dodd and Lincoln wrote a letter, dated June 30, 2010, to Representatives Frank and Peterson to offer clarification on this issue. The letter states in clear terms that the legislation "does not authorize the regulators to impose margin on end users." Further, the letter also states that the Congressional intent is to provide certainty to existing contracts and avoid any disruptions to them "for the sake of the economy and the financial system." Letter from Chairman Christopher Dodd, Senate Comm. on Banking, Hous., & Urban Affairs and Chairman Blanche Lincoln, Senate Comm. on Agric., Nutrition, & Forestry, to Chairman Barney Frank, House Fin. Services Comm. and Chairman Colin Peterson, House Comm. on Agric. (June 30, 2010), *available at* http://www.schiffhardin.com/PDFs/dodd-lincoln-letter070110.pdf [hereinafter Dodd-Lincoln Letter].

condition.[174] Under the provisions of the Act, swap dealers and major swap participants will maintain daily trading records along with "recorded communications," including e-mails, instant messages, and recorded telephone calls per the requirements of the Commissions.[175] They will also be required to maintain books and records of all their swap activities in the form and manner that the Commissions prescribe.[176] Swap dealers will further be required to "maintain a complete audit trail for conducting comprehensive and accurate trade reconstructions."[177]

Under the new regime, swap dealers and major swap participants will be subjected to "business conduct" rules adopted by the Commissions.[178] The Commissions will establish duties for swap dealers and major swap participants to verify their counterparties' status as eligible contract participants, to disclose material risks and characteristics of transactions, to disclose any "material incentives or conflicts of interest" they may have with respect to a transaction, and to communicate with their counterparties "in a fair and balanced manner based on principles of fair dealing and good faith."[179] Furthermore, the Commissions have broad authority to enact additional rules relating to fraud prevention and to curtail other manipulative and abusive practices that have the potential to impact adversely.[180]

4. *Duties with Respect to Special Entities*

Swap dealers and major swap participants will be required to take extra care when dealing with "special entities," which include: a Federal agency; a State, State agency, city, county, municipality, or other political subdivision of a State; an employee benefit plan; any governmental plan; or an endowment.[181] As an advisor to such a special entity, swap dealers and MSPs are prohibited from employing any device or scheme to defraud a special entity or engaging in any transaction or course of business that is basically fraudulent, deceptive or manipulative, or operates as a fraud or deceit on any special entity.[182] A swap dealer or MSP also has "a duty to act in the best interests of the Special Entity"[183] and make reasonable efforts to obtain information that is helpful in determining that a recommended swap is in the best interest of the special entity.[184]

As a counterparty to a special entity in a swap transaction, a swap dealer or a major participant must have a reasonable basis to believe that the special entity has an independent representative that (i) will act in the

174. Dodd-Frank Act § 731 (to be codified at 7 U.S.C. 4s(f)(1)(A)).
175. *Id.* (to be codified at 7 U.S.C. 4s(g)(1)).
176. *Id.* (to be codified at 7 U.S.C. 4s(f)(1)(B)).
177. *Id.* (to be codified at 7 U.S.C. 4s(g)(4)).
178. *Id.* (to be codified at 7 U.S.C. 4s(h)(1)).
179. *Id.* (to be codified at 7 U.S.C. 4s(h)(3)(A)-(C)).
180. § 763(g) (to be codified at 15 U.S.C. 78i(j)).
181. § 731 (to be codified at 7 U.S.C. 4s(h)(2)).
182. *Id.* (to be codified at 7 U.S.C. 4s(h)(4)(A)).
183. *Id.* (to be codified at 7 U.S.C. 4s(h)(4)(B)).
184. *Id.* (to be codified at 7 U.S.C. 4s(h)(4)(C)).

best interest of the entity; (ii) has no connection with the swap dealer or major swap participant; (iii) is knowledgeable to evaluate the risks involved in the transaction and provide written representations to the special entity regarding fair pricing and the appropriateness of the transaction; and (iv) in the case of employee benefit plans, is a fiduciary.[185] Before entering into a swap transaction with a special entity, a swap dealer or a MSP must also provide written disclosure to the special entity of the capacity in which they are acting.[186] It is important to note that these heightened requirements do not apply to transactions initiated by a special entity and executed on an exchange or swap execution facility where the identity of a counterparty is not known.[187]

B. Central Clearing, Trading, and Reporting

1. *Central Clearing*

OTC derivatives contracts are privately negotiated bilateral contracts. Because these contracts are not traded on organized exchanges with central clearinghouses, the credit risk in these contracts is borne by the individual counterparties.[188] To eliminate the credit risk, the Act mandates central clearing for derivatives that can be cleared.[189] The use of central counterparties (CCPs) in OTC derivatives markets will help mitigate counterparty risk—the risk associated with the failure of a party to fulfill its obligations to the other in a bilateral transaction.[190] A CCP is an independent legal entity that interposes itself between the buyer and the seller of a derivative security.[191] The presence of this third party in the bilateral OTC derivatives contracts "ensure[s] that every buyer has a guaranteed seller and every seller has a guaranteed buyer, thus minimizing the risk that one counterparty's default will cause a systemic ripple through the markets."[192]

The Act requires that all swaps be subject to mandatory clearing provided the CFTC or the SEC has determined that they be cleared and they are acceptable for clearing to a "derivatives clearing organization" (DCO) (in the case of a swap) or a clearing agency (in the case of a security-based swap).[193] A DCO or clearing agency must submit to the CFTC or SEC, as applicable, for their approval any group, category, type, or class of swaps that it intends to clear, and provide notice of the submis-

185. *Id.* (to be codified at 7 U.S.C. 4s(h)(5)(A)(i)(I), (III)-(IV), (VII)).
186. *Id.* (to be codified at 7 U.S.C. 4s(h)(5)(A)(ii)).
187. *Id.*
188. *See* Stephen G. Cecchetti et al., *Central Counterparties for Over-the-Counter Derivatives*, BIS Q. Rev., Sept. 2009, at 45, 47.
189. Dodd-Frank Act § 723(a)(3) (to be codified at 7 U.S.C. 2 (h)).
190. *See* Cecchetti et al., *supra* note 188, at 45.
191. *Id.*
192. *Review of Credit Derivatives Before the Subcomm. On General Farm Commodities and Risk Management of the H. Comm. on Agriculture*, 110th Cong. (2008) (statement of Walter Lukken).
193. Dodd-Frank Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(1)(A)).

sion to its members.[194] It is the responsibility of the CFTC or SEC, as applicable, to make the submissions available to the public, make its determination as to whether clearing is required for the derivative, and provide at least a thirty day public comment period regarding its determination.[195] The CFTC or SEC has ninety days from the day of receipt of submission to make a determination.[196] In addition to the submissions made by clearing organizations, the CFTC or SEC may itself initiate review of any group, category, type or class of swap to determine whether mandatory clearing should apply.[197] In determining which swaps need to be cleared, the regulators should consider the following factors: (i) existence of notional exposures, trading liquidity and pricing data; (ii) the availability of operational expertise and relevant infrastructure for clearing; (iii) the effect on mitigation of systemic risk and on competition; and (iv) the existence of reasonable legal certainty in the treatment of customer and swap counterparty positions, funds and property in the event of insolvency of the clearinghouse.[198]

Clearinghouses do not have their own funds to deal with the defaults of their participants and absorb losses resulting from them.[199] Instead, they depend on a system of margin or collateral.[200] Traders are required to deposit an initial margin payment with the clearinghouse before the trade

194. *Id.* (to be codified at 7 U.S.C. 2(h)(2)(B)(i)). The Act requires clearing organizations to register with the CFTC in order to clear swaps and with the SEC in order to clear security-based swaps. To be able to register or maintain its registration with the applicable agency, a DCO must meet an extensive set of criteria, with the most important criteria being: (1) each DCO must have adequate financial, operational and managerial resources, as determined by the CFTC or SEC, respectively; (2) each DCO must possess financial resources that, at a minimum, exceed the total amount that would (a) enable the DCO to meet its financial obligations to its members and participants, notwithstanding a default by the member or participant creating the largest financial exposure for the DCO in "extreme but plausible market conditions;" and (b) enable the DCO to cover the costs of the DCO for a one-year period; (3) each DCO must establish and implement procedures to verify the compliance of each participation and membership requirement of the DCO on an ongoing basis; (4) each DCO must (a) not less than once during each business day, measure the credit exposures of the DCO to each member and participant of the DCO, and (b) monitor each such exposure periodically during the business day of the DCO; (5) each DCO, through margin requirements and other risk control measures, must limit its exposure to potential losses from default by its members and participants; (6) each DCO must have rules and procedures designed to allow for the efficient, fair, and safe management of events in the event of a member or participant's insolvency or default on their obligations to the DCO. *Id.* § 725 (to be codified at 7 U.S.C. 7a-1(c)(2)).

195. § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(2)). The Commissions are required to establish, within one year of enactment, rules for the submission and review of derivatives accepted by clearinghouses for clearing. *Id.* (to be codified at 7 U.S.C. 2(h)(2)(E)).

196. *Id.* (to be codified at 7 U.S.C. 2(h)(2)(C)). The ninety-day review period may be extended up to ninety days or longer by the reviewing agency on application of counterparty or on its own initiative. *Id.*

197. *Id.* (to be codified at 7 U.S.C. 2(h)(2)(A)(i)).

198. *Id.* (to be codified at 7 U.S.C. 2(h)(2)(D)).

199. *See* MILLER, *supra* note 65, at 2.

200. *See id.*

to cover any future potential losses.[201] "Then at the end of each trading day, all contracts are repriced, or "marked to market," and all those who have lost money (because prices moved against them) must respond to the margin call and post additional margin (called variation or maintenance margin) to cover those losses before the next trading session."[202] Under the provisions of the Act, swap counterparties of cleared transactions that are not cleared by a registered DCO will be required to post initial and variation margins.[203] Posting margins would result into reduced liquidity and potential increased costs for the counterparties—according to the International Monetary Fund's (IMF) report, upfront costs to dealers from posting of the initial margin and contributions to CCPs' guarantee fund would be up to $150 billion.[204] Further, dealers will not be able to re-use (by lending, pledging, investing, or rehypothecating) the funds and securities posted as collateral at the CCP and will suffer a loss on the potential interest income.[205] Though margins are not required from end users, there is a possibility that end users might get impacted indirectly from increased costs resulting from posting of margins if those costs are passed through to them from the dealers.[206] The increased costs of transactions might deter counterparties from entering into derivatives transactions, but the good news is that the industry recognizes the value of clearinghouses as a means of reducing risk and has already cleared over $200 trillion of interest rate swaps despite these costs.[207] As clearinghouses further develop their ability to clear a variety of products with more firms and make OTC derivatives markets safe for trading, they will be able to attract more dealers to clear their trades through them, even with all costs attached as the benefits of clearing outweigh these costs.

Additionally, the changed scenario will see market participants as members of several DCOs or clearing agencies. It is not clear, though, if their membership of multiple DCOs and/or clearing agencies would allow them to enjoy the advantages of netting and margin posted, not just across products, but also across clearing platforms.[208] While there is no express prohibition on clearing organizations to provide such a benefit to the members, under the provisions of the Act, the clearing organizations cannot be compelled to accept the counterparty credit risk of another clearing organization if there is risk to its financial integrity.[209]

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201. *Id.*
202. *Id.*
203. Dodd-Frank Act § 731(a)(3) (to be codified at 7 U.S.C. 4s(e)(2)(B)(ii)).
204. INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: MEETING NEW CHALLENGES TO STABILITY AND BUILDING A SAFER SYSTEM 101 (2010), *available at* http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf.
205. *Id.*
206. As noted above, the issue of exemption from margin for end users requires clarification as the Act does not expressly exempt end users from such requirement.
207. Letter from Conrad Voldstad, CEO, Int'l Swaps & Derivatives Ass'n, to International Monetary Fund (Apr. 26, 2010), *available at* http://www.isda.org/speeches/pdf/IMF-Letter-Revised.pdf.
208. *See* Dodd-Frank Act § 723(a)(3) (to be codified at 15 U.S.C. 78a).
209. *Id.* (to be codified at 7 U.S.C. 2(h)(4)(C)).

Commercial End User Exemption to Clearing: Corporations use derivatives for hedging or mitigating business risks, but under the new law such end users of derivatives have been exempted from the mandatory clearing requirement.[210] Consequently, end users will also enjoy exemption from exchange trading and possibly margin requirements. Under the provisions of the Act, there is an optional exemption from the clearing requirement to a swap counterparty that (i) is not a "financial entity," (ii) is using the swap to hedge or mitigate commercial risk, and (iii) notifies the CFTC or SEC, as applicable, how it generally meets its financial obligations associated with entering into uncleared swaps.[211] An exempted counterparty has the option to clear swap contracts with a clearinghouse if such counterparty chooses to do so; the counterparty also can choose the clearinghouse it wishes to use for the purpose.[212] For the purposes of this exemption, it is important to understand what the term "financial entity" stands for because the exemption has been granted to counterparties that are not "financial entities." The Act defines a "financial entity" as a swap dealer or a major swap participant as defined in the Act, a commodity pool as defined in the CEA, a private fund as defined in section 202(a) of the Investment Advisers Act of 1940, an employee benefit plan as defined under ERISA, or a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature.[213] This exemption is strictly for corporate end users engaged in hedging transactions and will not be extended to entities like hedge funds, irrespective of their status as major swap participants or not.[214] But the definition expressly excludes certain captive finance companies whose primary business is providing financing, and which use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, ninety percent or more of which arise from financing that facilitates the purchase or lease of products, ninety percent or more of which are manufactured by the parent company or another subsidiary of the parent company.[215] In plain language, captive finance companies, i.e. those affiliate companies that are wholly owned by a parent company and whose primary business is to provide financing for customers purchasing or leasing the parent company's products – will be exempt from clearing requirements for swaps entered to mitigate risk related to interest rate and foreign exposures. Further, the Act leaves it to the discretion of the CFTC and SEC to exempt small banks, savings associations, farm credit system institutions, and credit unions with total assets not exceeding $10 billion from the definition of a "financial entity".[216] Whether these institutions will be ex-

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210. *Id.* (to be codified at 7 U.S.C. 2(h)(7)(A)).
211. *Id.*
212. *Id.* (to be codified at 7 U.S.C. 2(h)(7)(B)).
213. *Id.* (to be codified at 7 U.S.C. 2(h)(7)(C)).
214. *Id.*
215. *Id.*
216. *Id.*

cluded or not from the definition will become clear only after the completion of the rulemaking process of the Commissions.

Effect on Existing Trades: Swaps entered into before the date of the enactment of the Act are exempt from the clearing requirements as long as they are reported to a swap data repository or to the Commissions no later than 180 days of such date.[217] Additionally, swaps entered into before the clearing mandate is effective are exempt if reported to a swap repository or the Commissions within ninety days after the Effective date or at such other time as the applicable Commission may prescribe.[218]

2. *Trading*

OTC derivatives are not exchange-traded, however, to improve transparency, promote efficiency, and reduce systemic risk in the OTC derivatives market, the Act requires all cleared swaps to be traded on a designated contract market,[219] or a registered swap execution facility (in the case of a swap), or a national securities exchange, or a security-based swap execution facility (in the case of a security-based swap).[220] A "swap execution facility" is a facility "in which multiple participants have the ability to execute or trade swaps by accepting bids and offers" made by other participants in the facility, through any means of interstate commerce.[221] The trading requirement of the Act will not apply in the case of uncleared swaps of counterparties opting to exercise the commercial end user exemption for clearing.[222] Exchange trading will bring price transparency to OTC derivatives trading, as the prices of the trades will be published, and will become easily accessible to the public.[223] Exchanges have improved the functioning of the existing securities and futures markets by producing better price information and a more liquid market, and, hopefully, will be able to do the same for OTC markets.[224]

3. *Reporting and Publication of Transaction Data*

In order to improve market transparency and provide regulators tools for monitoring derivatives trading activity, the new regulatory regime requires collection and publication of data through clearinghouses or swap repositories.[225] Swaps not accepted for clearing by a clearing organiza-

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217. *Id.* (to be codified at 7 U.S.C. 2(h)(5)).
218. *Id.*
219. A swap contract with a party that is not an "eligible contract participant" must be entered into on a designated contract market. An "eligible contract participant" includes, subject to limitations, financial institutions, insurance companies, investment companies, commodity pools, employee benefit plans, government entities, brokers, dealers, high net worth individuals, and others. 7 U.S.C. § 1a (2011).
220. Dodd-Frank Act § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(8)(A)).
221. § 721(a)(21) (to be codified at 7 U.S.C. 1a).
222. § 723(a)(3) (to be codified at 7 U.S.C. 2(h)(7)(A)).
223. Chairman Gary Gensler, Remarks Before SIFMA Post-Financial Reform Conference (Jul. 15, 2010), *available at* http://www.cftc.gov/pressroom/speechestestimony/opagensler-49.html.
224. *Id.*
225. Dodd-Frank Act § 727 (to be codified at 7 U.S.C. 2(a)(13)).

tion must be reported to a registered swap repository or a "registered securities-based swap repository," as applicable.[226] In case a swap repository does not accept the report or there is no swap repository to report to, the data should be reported to the CFTC or SEC.[227] The Act defines a "swap data repository" as "any person that collects and maintains information or records with respect to transactions or positions in, or the terms and conditions of, swaps entered into by third parties for the purpose of providing a centralized recordkeeping facility for swaps."[228] Swap data repositories are required to register with the CFTC or SEC.[229] They are also required to make available on a confidential basis all data obtained by such repositories to (a) each appropriate prudential regulator; (b) the Financial Stability Oversight Council; (c) the SEC; (d) the Department of Justice; and (e) any other person that the CFTC or SEC determines to be appropriate, including foreign financial supervisors, central banks, and ministries.[230] The swap data repositories shall also "establish and maintain emergency procedures, backup facilities, and a plan for disaster recovery that allows for the timely recovery and resumption of operations and the fulfillment of the responsibilities and obligations of the organization."[231]

The responsibility for reporting uncleared swaps, for the most part, lies with swap intermediaries and not end users.[232] For example, if one of the parties to the contract is a swap dealer or a major swap participant, the responsibility lies with the swap participant or major swap participant.[233] In a contract between a swap dealer and a major swap participant, the swap dealer has the responsibility to report.[234] But, where neither party is a swap dealer or a major swap participant, or where both parties are either swap dealers or major swap participants, then it is the responsibility of the counterparties to decide which party will report.[235] The Act leaves it to the discretion of the CFTC or SEC to promulgate rules concerning the timing and content of the reports.[236] Further, the Act mandates that the CFTC or SEC promulgate rules and regulation for the "real-time public reporting" of swap transaction and pricing data to enhance price discovery.[237] "Real time public reporting" is defined as public dissemination of data, including price and volume, "as soon as technologically practicable after the time at which swap transaction has been executed."[238] Real-time public reporting will apply to all swaps that

226. *Id.* (to be codified at 7 U.S.C. 2(a)(13)(C)).
227. § 729 (to be codified at 7 U.S.C. 6o-1(4r)(a)(1)(B)).
228. § 721(a)(21) (to be codified at 7 U.S.C. 1a).
229. § 728 (to be codified at 7 U.S.C. 24(21)(g)).
230. *Id.* (to be codified at 7 U.S.C. 24(21)(c)(7)).
231. *Id.* (to be codified at 7 U.S.C. 24(21)(c)(8)).
232. Dodd-Frank Act § 729 (to be codified at 7 U.S.C. 6o-1(4r)(a)(3)).
233. *Id.*
234. *Id.*
235. *Id.*
236. *Id.* (to be codified at 7 U.S.C. 6o-1(4r)(a)(1)(B)).
237. § 727 (to be codified at 7 U.S.C. 2(a)(13)(E)).
238. *Id.* (to be codified at 7 U.S.C. 2(a)(13)(A)).

are subject to the mandatory clearing requirement, including those that are exempt from the clearing requirement pursuant to end users exemption, and swaps that are not subject to mandatory clearing, but are accepted by a registered DCO or clearing agency.[239] For transactions that are not cleared but are reported to a swap data repository or the Commissions, as applicable, the Act requires the CFTC or SEC to promulgate rules that ensure the details of the business transactions or market positions of any person are not disclosed and the parties are not identified.[240] The concern that real-time price reporting of trades will come in the way of execution of block trades has been addressed under the Act and the Commissions have been authorized to specify criteria for determining what constitutes a block trade for particular markets in order to institute appropriate time delays of the reporting of such transactions.[241] In promulgating these rules and regulations, the CFTC or SEC is required to take into account whether public disclosure would materially reduce market liquidity.[242] Finally, the CFTC or SEC will issue semiannual or annual reports on the trading and clearing of major swap categories and the market participants and development of new products.[243]

C. The Swaps Push-Out Rule[244]

The controversial "push-out" provision, originally proposed by Senator Blanche Lincoln to the Senate Agriculture Committee, was modified and a substantially moderated version of the provision is included in the Act.[245] Under § 716 of the Act, commonly known as "swaps push-out rule", no federal assistance will be provided to registered swap dealers and major swap participants "with respect to any swap, security-based swap, or other activity of the swaps entity."[246] The Act defines "Federal assistance" as:

> the use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility under section 13(3)(A) of the Federal Reserve Act, Federal Deposit Insurance Corporation insurance or guarantees for the purpose of:
>
> (A) Making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity;

239. *Id.* (to be codified at 7 U.S.C. 2(a)(13)(C)).
240. *Id.* (to be codified at 7 U.S.C. 2(a)(13)(E)).
241. *Id.*
242. *Id.*
243. *Id.* (to be codified at 7 U.S.C. 2(a)(14)(A)).
244. § 716.
245. *See generally* Matthew Leising, *New Democrats Seek Swaps Trading Change, Oppose Lincoln Plan*, Bloomberg Businessweek, Jun. 16, 2010, http://www.businessweek.com/news/2010-06-16/new-democrats-seek-swaps-trading-change-oppose-lincoln-plan.html; Phil Mattingly, *House Democrats Target Senator Lincoln's Swaps-Desk Proposal*, Bloomberg Businessweek, May 25, 2010, http://www.*businessweek.com/news/2010-05-25/house-democrats-target-senator-lincoln-s-swaps-desk-proposal.html*.
246. Dodd-Frank Act § 716(a).

(B) Purchasing the assets of any swaps entity;
(C) Guaranteeing any loan or debt issuance of any swaps entity; or entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity; or
(D) Entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity.[247]

Furthermore, a "swap entity" for the purposes of federal assistance prohibition includes any swap dealer, security-based swap dealer, major swap participant or major-security-based swap participant registered with the CFTC or SEC, except insured depository institutions that are major swap participants.[248] An insured depository institution acting as swap dealers, though, will be considered a "swap entity" under the provisions of the Act. These insured depository institutions acting as swap dealers are exempted from the prohibition on federal assistance under the Push-Out Rule, as long as they engage in the following expressly permitted swap activities:

(1) Hedging and other similar risk mitigating activities directly related to the insured depository institution's activities;
(2) Acting as a swaps entity for swaps or security-based swaps involving rates or reference assets that are permissible for investment by a national bank under the paragraph designated as "Seventh" of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), other than as described in paragraph (3)[249]

and acting as a swaps entity for credit default swaps that are cleared by a derivatives clearing organization or a clearing agency.[250]

Hence, these depository institutions would be required to limit their swap activities to only those that are specifically permitted under the Act and push out all other kinds of swaps that are based on reference assets, not permissible for investment by national banks, such as most commodities and equity securities, as well as uncleared CDS, unless they enter into these transactions for hedging purposes. In simple words, banks or other entities that have access to Federal Reserve credit or FDIC assistance, and that currently deal with swaps and wish to continue their business as

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247. § 716(b)(1).
248. § 716(b)(2)(A).
249. While national banks can invest in a wide array of assets, including loans, notes, other extensions of credit, foreign currency, gold and other precious metals, U.S. government and agency securities, investment grade commercial or residential mortgage-related securities, marketable investment-grade asset-backed securities, and other similar obligations, they are expressly prohibited to deal in equity securities. § 716(l).
250. *Id.* There is a possibility that these permitted activities may be banned in the future if the Financial Stability Oversight Council, established under the Dodd-Frank Act, makes such determination. Such determinations will be institution-specific and will require affirmative vote of two-thirds of its members, including the chairperson. § 121.

swap dealers or as major swap participants would lose their eligibility for federal assistance unless they spin off their swap businesses which deal with activities outside of permitted swap activities under the Act, to another entity, or divest or cease to engage in that business. An insured depository institution may establish or maintain an affiliate that is a swaps entity (registered dealer or MSP) provided the following conditions are satisfied: (1) the insured depository institution is part of a bank holding company that is supervised by the Federal Reserve, and (2) such swaps entity affiliate satisfy the requirements of Sections 23A and 23B of the Federal Reserve Act that govern transactions with the affiliated bank and any other requirements as prescribed by the Federal Reserve, the CFTC or SEC.[251]

The Swaps Push-Out Rule will be effective two years following the effective date of the Act, which will be approximately three years after enactment of the Act.[252] If the insured depository institution which qualifies as a "swaps entity" is interested in retaining its eligibility for Federal assistance, then the appropriate Federal bank regulatory agency will allow them an additional twenty-four month transition period, plus a year's extension.[253] The one-year extension is discretionary and would be allowed by the Federal bank regulatory agency only after consultation with the CFTC and the SEC.[254] During the transition period, such insured depository institutions will be required to cease the activities that require registration as a swaps entity by allowing them to push out their swap business into an affiliate of the bank holding company or to another entity.[255] Any swaps entered into by these institutions before the expiration of the transition period will remain unaffected by the prohibitions of § 716.[256]

The discussion on the "Swap Push-Out" provision cannot be complete without the mention of the restrictions imposed by new Section 13 of the Bank Holding Company Act, which is commonly referred to as the "Volcker Rule,"[257] first proposed by Paul Volcker, former chairman of the Board of Governors of the Federal Reserve System and the current head of the President's Economic Recovery Advisory Board.[258] Although the Volcker Rule is included under Title VI of the Dodd-Frank Act, its mention here is important because the Lincoln Provision mandates insured depository institution's compliance with the limitations on proprietary trading of the Volcker Rule.[259] The "Volcker Rule," prohib-

251. § 716(c).
252. § 716(f).
253. *Id.*
254. *Id.*
255. *Id.*
256. § 716(e).
257. § 619 (to be codified at 12 U.S.C. § 1851(13)).
258. *Chairman Paul A. Volcker*, White House, http://www.whitehouse.gov/administration/eop/perab/members/volcker (last visted Feb. 9, 2011).
259. Under the Dodd-Frank Act, a new Section 13 has been added to the Bank Holding Company Act of 1956 and provides that a banking entity shall not engage in pro-

its insured banks and other "banking entities" from making speculative bets for their own account, known as proprietary trading, subject to limited exceptions.[260] Proprietary trading has been defined as engaging as a principal for the "trading account" of a banking entity in any transaction to purchase or sell, or otherwise acquire or dispose of, (1) any security, derivative, or contract of sale of a commodity for future delivery, (2) any option on any such security, derivative, or contract, or (3) other security or financial instrument that the appropriate Federal banking agencies, the CFTC or SEC (the "regulators"), may determine.[261] The "trading account" of a banking entity is defined as (1) any account used to acquire or take positions in securities or financial instruments principally for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short-term price movements, and (2) any other accounts as the applicable regulators may determine.[262]

The prohibition on proprietary trading, however, excludes (a) underwriting and market-making activities to the extent such activities are designed not to exceed the reasonably-expected near term demands of clients, customers, or counterparties; (b) risk-mitigating hedging activities that are designed to reduce specific risks to the banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings; (c) customer-driven investments; (d) investments in government and government-related obligations; and certain other permitted activities.[263] These permitted activities will remain permitted as long as they do not involve or result in a potential conflict of interest between the banking entity and its clients, customers, or counterparties, or would pose a threat to the safety and soundness of the banking entity or to the financial stability to the United States.[264]

Though it was strongly felt by Paul Volcker, Treasury Secretary Timothy Geithner, FDIC Chairman Sheila Bair, and others in the government and the derivatives industry that the Volcker Rule effectively addresses risks and potential conflicts posed by banking organization's proprietary trading in derivatives, Senator Lincoln believed that the Rule does not go far enough to address the issue of risk in the nation's banking sector and pushed hard for her amendment.[265] Together, the two provisions will achieve the result desired for this legislation, which is to substantially limit the derivatives activities of insured depository institutions

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prietary trading or acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund. Dodd-Frank Act § 619 (to be codified at 12 U.S.C. § 1851(13)).

260. Any insured depository institution or thrift, any company that controls an insured depository institution or thrift, any company that is treated as a bank holding company under Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of such an entity. *See* 12 U.S.C. § 1851(h)(1) (2010).

261. Dodd-Frank Act § 619 (to be codified at 12 U.S.C. § 1841(13)(h)(4)).

262. *Id.* (to be codified at 12 U.S.C. § 1841(13)(h)(6)).

263. *Id.* (to be codified at 12 U.S.C. § 1841(13)(d)(1)).

264. *Id.* (to be codified at 12 U.S.C. § 1841(13)(d)(2)(A)).

265. Edward Wyatt, *In Tough Stance, Democrat Finds Few Allies*, N.Y. TIMES, May 15, 2010, http://www.nytimes.com/2010/05/16/us/politics/16derivatives.html.

and their affiliates. Hence, a spun-off entity that is an affiliate of an insured depository institution as well as any insured depository institution that continues to engage in swap business (limited to permitted swaps) would be equally subject to the Volcker Rule, and as a result, engage in only limited swap activities. Further, in addition to satisfying the requirements set forth in the Act for swap dealers, the spun-off entity would also be required to be independently capitalized so as to qualify as a participant in a clearing organization and to obtain credit rating that would give confidence to counterparties to enter into transactions with the entity. There is no doubt that losing the advantage of housing OTC derivatives within the lead bank and "moving positions to a different subsidiary can have material franchise, operational and, possibly, capital implications for U.S. dealers."[266] The insured depository institutions providing capital to spun-off entities would, in turn, find themselves in a tough situation, as it would limit their ability to extend credit. In addition, in their effort to find a cost-efficient solution to the situation, U.S. dealers might consider moving their business to London-based regulated broker-dealer subsidiaries, which would not only take business away from the United States but would also make it difficult and complex to unwind positions, thus potentially increasing systemic risk.[267] To avoid such a situation, it is important that serious work be done simultaneously to accomplish international harmonization of rules and regulations concerning OTC derivatives.

D. Implications of Title VII for Financial Institutions, Hedge Funds, and End Users

1. *Financial Institutions*

Financial institutions that qualify as swap dealers, under the definition of the Act, will have to register with the CFTC as swap dealers and with the SEC as security-based swap dealers, within a year of the enactment of the Act.[268] As a swap dealer or security-based swap dealer, they will be subject to minimum capital and margin requirements.[269] They will also be subject to reporting and recordkeeping requirements, and business conduct standards in dealing with their counterparties and customers, and "special entities".[270] Needless to say that as a result of the provisions of the Act, the cost of using derivatives will increase. The provisions of the new law are likely to impact liquidity in the market as capital will be reserved and financial institutions will have to post initial and variation margins for their trade positions. But the major change for financial institutions, that are also insured depository institutions, would come from

266. Alexander Yavorsky, *Swaps Push-Out to Have Major Impact on U.S. Dealers*, Compliance Week, 1 (June 21, 2010), http://www.complianceweek.com/s/documents/MoodysPushOut.pdf.
267. *Id.* at 2.
268. Dodd-Frank Act § 731 (to be codified at 7 U.S.C. 1 §§ (4s)(a)(1), (c)(1)).
269. *Id.* (to be codified at 7 U.S.C. 1 (4s)(e)(1)(A)).
270. *Id.* (to be codified at 7 U.S.C. 1 (4s)(f)).

the "swap push-out" provision, which prohibits "federal assistance" to registered swap dealer and major swap participants.[271] These institutions are allowed to continue as swap dealers to hedge their own activities and enter into interest rate swaps as well as swaps referencing assets permitted for investment by a national bank, and still remain eligible for "federal assistance."[272] But for all other swap activity, these institutions will have to push-out their derivatives desk to a separately capitalized entity (which may be an affiliate controlled by the same bank holding company) that will be responsible for satisfying requirements for a swap dealer.[273] In addition, the derivatives activities of financial institutions will be further restricted under the Volcker Rule, which bans proprietary trading in derivatives by "banking entities."[274]

2. *Hedge Funds*

Hedge funds may qualify as "major swap participants," if their outstanding swaps give rise to substantial counterparty exposure that has the potential to adversely affect the financial stability of the U.S. banking system or financial markets.[275] If classified as a "major swap participant," they will be required to register with the appropriate agency, the CFTC or the SEC, and be subject to capital and margin rules, reporting and recordkeeping requirements, and business conduct standards, expected of such entities under the Act.[276] Additionally, even if hedge funds fail to meet the above noted criteria for MSPs, their swap transactions will still be required to be cleared and executed on an exchange or a swap execution facility, if they are a highly leveraged financial entity and maintain a substantial position in outstanding swaps in a major category.[277] Further, there is a possibility that funds entering into swaps may be treated as commodity pools and their managers and advisors be subjected to regulations as commodity pool operators and commodity trading advisors.[278] If they fall under either of these classifications, they will be required to register as a "commodity pool operator" (CPO) or "commodity trading advisor (CTA)," and subjected to disclosure, periodic reporting, audit, and other requirements under the Act.[279] Until the applicable rules and regulations are promulgated, there will not be any clarity as to how each hedge fund will be categorized. There is no problem for those hedge funds that engage in large-scale derivatives trading for they already have an understanding as to how they will be categorized. For that matter, hedge funds with very small swap portfolio need

271. § 716(a).
272. § 716(d)(1)-(2).
273. *See* §§ 716, 731.
274. § 619 (to be codified at 12 U.S.C. § 1851(13)).
275. 7 U.S.C. § 1a(33)(A)(ii) (2010).
276. Dodd-Frank Act § 731 (to be codified at 7 U.S.C. 1 §§(4s)(a)(2), (e), (f)).
277. 7 U.S.C. § 1a(33)(A)(iii)(I).
278. § 1a(10)(A)(i).
279. 7 U.S.C. § 6n(3)(A).

not worry either. The dilemma is only for those who fall in the middle. They are the ones who need to know how broad the new rules will be and under the new rules, which category will they fall under. Going by the tone of the legislation, it will probably be in their best interest to be prepared for compliance with the new law.

3. *Corporate End Users*

Corporate end users, under the Act, are exempted from having to register as a "major swap participant," and are thereby relieved from the clearing, exchange trading, and possibly margin requirements, as long as they enter into swap transactions to hedge their business risks.[280] But, the Act does provide them with the option to submit their trades for clearing.[281] If they choose not to opt for clearing of their trade, then the Act does not provide any guidance as to whether they will be required to post margin, even if noncash, in connection with such trade. It is important to note that margin is required for all uncleared swaps and the Act fails to provide explicit exemption from margin for business end users. To address the growing concern about this issue, Senators Christopher Dodd and Blanche Lincoln offered clarification in a letter dated June 30, 2010.[282] In their letter, they emphasized that "[t]he legislation does not authorize regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk."[283] The letter obviously is not legally binding and how much of an impact it will have on the future rulemaking remains to be seen.[284]

Another area of concern for end users is the possibility that the risk-mitigating swaps of large corporate end users might put them in the category of "major swap participants," as the terms "substantial position," "substantial counterparty exposure," and "highly leveraged," used in the definition of "major swap participants," have been left either unexplained or to be defined by the Commissions.[285] Hence, until such time that the Commissions provide guidance on this issue through detailed definitions, end users, particularly highly leveraged financial entities not subject to regulatory capital requirements and holding substantial position in outstanding swaps in any major swap category, will be better off if they could avoid holding large positions in outstanding swaps in any major swap category. End users should also consider monitoring their status on a regular basis so that they understand where they stand as far as their being classified as a "major swap participant" goes. Further, it is important for

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280. Dodd-Frank Act § 763 (to be codified at 15 U.S.C. § 78a (3c)(g)(1)).
281. *Id.* (to be codified at 15 U.S.C. § 78a(3c)(g)(2)).
282. Dodd-Lincoln Letter, *supra* note 173.
283. *Id.*
284. The exemption from mandatory margin requirement for end users was removed from the bill during the conference process. *Policy Report: Derivatives Reform Signed Into Law as Part of Dodd-Frank Legislation*, REIT.COM, July 22, 2010, *available at* http://www.reit.com/PolicyPolitics/OtherFederalLegislation/DerivativesLegislation/NAREIT%20Policy%20Report%207-22-10.aspx.
285. Dodd-Frank Act §712(d)(1).

end users to appreciate that because of the divided jurisdictions between the CFTC and the SEC, entities who hold positions in both swaps and security-based swaps, might find themselves being regulated by the two Commissions as a "major swap participant" and a "major security-based swap participant."[286]

V. CONCLUSION

The financial crisis exposed weaknesses in the U.S. financial system and led to the enactment of the Dodd-Frank Act to fix the flaws in the weak system. The new legislation makes fundamental changes to the regulatory landscape to bring stability to the financial system and the economy. Most of the provisions of Title VII will be effective by July 16, 2011 (the "Effective Date"), which is 360 days after July 21, 2010, the date of the enactment of the Act (the "Enactment Date"). Other provisions that require additional rulemaking by different federal agencies will become effective not less than 60 days after publication of the final rule or regulation implementing such provision. This means that the derivatives market and industry will not experience drastic changes overnight. But the legislation will definitely get them thinking as to what their future course of action is going to be now that the Act has been enacted. The Act requires swap dealers and security-based swap dealers to register with the CFTC and the SEC, respectively. Pursuant to registration, swap dealers and major swap participants will be subject to increased capital and margin requirements, and heightened business conduct requirements. The capital and margin requirements will not only increase transactions costs, but will also affect liquidity in the market as the traders post initial margin and variation margin to keep up with changes in the values of positions. Most importantly, insured depository institutions that are part of bank holding companies and are swap dealers will have to push-out their swap trading desks to affiliates that are swap entities in order to remain eligible for "federal assistance." Additionally, they will also be prohibited from engaging in proprietary trading for their own accounts. These key aspects of the derivatives legislation will influence the decision-making of the derivatives participants to determine if they wish to continue with their derivatives business and in what form.

Even though enactment of the Act has cleared some air and provided some level of certainty, the full scope of the legislation will be known only after the completion of rulemaking process and adoption of additional rules and regulations to implement the legislation. In fact, it would not be farfetched to say that the success of this legislation will largely depend on the rules to be written by the CFTC and the SEC. It is being speculated that if the Commissions write stringent rules that end up creating a rigorous regulatory environment for the United States-based dealers then it is possible that these dealers might move their OTC derivatives

286. §731(to be codified at 7 U.S.C. (4s)(c)).

desks to their London-based regulated broker-dealer subsidiaries to take advantage of regulatory arbitrage opportunities. But again, this speculation is not very different from the speculation that arose after the enactment of the Sarbanes-Oxley Act of 2002, and which eventually fell flat. But it is worth highlighting that the difference between the two Acts is that the Dodd-Frank Act not only prohibits financial institutions from engaging in proprietary trading on their own accounts, but also requires them to push-out their swap trading desks to an affiliate. In this scenario, these institutions have to find a home for their derivatives business and when looking for it they might be tempted to take it to a place where the regulatory environment is comparatively less severe. No doubt that migration of business to foreign markets would take these institutions out of the reach of the U.S. regulators and will also affect U.S. competitiveness in the global markets adversely. But such an outcome can be avoided if the United States is successful in bringing about international harmonization of rules impacting derivatives markets worldwide and remove any opportunities for regulatory arbitrage. Given the global nature of the OTC derivatives market and the cross-border impacts of the recent market problems faced worldwide, achieving this would not be hard. Already the Group of Twenty (G-20),[287] the Financial Stability Board (FSB),[288] and international standard setting bodies, such as International Organization of Securities Commissions (IOSCO),[289] are pushing for global OTC

287. The Group of Twenty (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialized and developing economies to discuss key issues in the global economy. *About* G-20, G-20, http://www.g20.org/about_what_is_g20.aspx (last visited Feb. 9, 2011).

288. The FSB was established to coordinate the work of national financial authorities and international standard setting bodies to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of international financial stability. The FSB is chaired by Mario Draghi, Governor of the Bank of Italy. Its Secretariat is located in Basel, Switzerland, and is hosted by the Bank for International Settlements. The FSB met in Seoul on October 20, 2010, ahead of the G-20 summit and approved a report containing recommendations to promote consistent implementation of the G-20 commitments concerning: increasing the proportion of the market that is standardized; moving to central clearing of OTC derivatives by (i) implementing mandatory clearing requirements, (ii) strengthening oversight and regulation of central counterparties (CCPs) and (iii) introducing robust risk management requirements for the remaining non-centrally cleared markets; trading on exchanges or electronic platforms, where appropriate, by asking IOSCO to complete an analysis by the end of January 2011; and ensuring that OTC derivatives transactions are reported to trade repositories. *About the FSB: Overview*, FIN. STABILITY BD., http://www.financialstabilityboard.org/about/overview.htm (last visited Dec. 31, 2010); *Financial Stability Board Agree Tighter Watch Over Gib Financial Firms Ahead of the G20 Summit in Seoul*, ASYMPTOTIX, Oct. 20, 2010, http://www.asymptotix.eu/content/financial-stability-board-agree-tighter-watch-over-big-financial-firms-ahead-g20-summit-seou.

289. IOSCO is recognized as the leading international policy forum for securities regulators. It has formed a Task Force on OTC Derivatives Regulation (Task Force) in order to coordinate securities and futures regulators' efforts to work together in the development of supervisory and oversight structures related to OTC derivatives markets. The purpose of the Task Force is to seek to develop consistent international standards related to OTC derivatives regulation in the areas of

derivatives reform by bringing consistency in international financial regulatory standards. Most major financial jurisdictions have expressed their intent to align their efforts for reforms in their financial markets with the reforms proposed under the Dodd-Frank Act. The European Commission's legislative proposal for a Regulation on OTC derivatives, central counterparties and trade repositories, introduced on September 15, 2010, is fairly close to the provisions of the Dodd-Frank Act.[290] Likewise, amendments were made to the Japanese Financial Instruments and Exchange Act (FIEA) in May 2010.[291] The amended FIEA mirrors the Dodd-Frank Act in many respects.[292] With similar laws in place, major financial markets overseas will not be a lucrative option for United States-based dealers contemplating migration of their businesses.

Finally, there is no denying that OTC derivatives contracts serve a useful function in helping businesses mitigate their risk and making capital markets more efficient. Congress recognized that the elimination of the OTC markets would cause more harm than good and did not ban use of OTC derivatives. The Commissions, when crafting rules, should also keep in mind that these markets are critical for financial innovation and that the new rules should not have the effect of restricting innovation in financial markets as it spurs economic growth.[293] Though the Dodd-Frank Act is a tough law, it is a constructive step in the right direction, and the success of the financial reform process that has begun with the enactment of the Dodd-Frank Act will be reflected in a safe and sound financial system that fosters innovation.

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clearing, trading, trade data collection and reporting, and the oversight of certain market participants; to coordinate other international initiatives relating to OTC derivatives regulation; and to serve as a centralized group within IOSCO through which IOSCO members can consult and coordinate generally on issues relating to OTC derivatives regulation. The Task Force will be led by the U.S. Securities and Exchange Commission, the U.S. Commodity Futures Trading Commission, the UK Financial Services Authority and the Securities and Exchange Board of India. *Implementing OTC Derivatives Market Reforms*, FIN. STABILITY BD., 4, 64 (Oct. 25, 2010), http://www.financialstabilityboard.org/publications/r_101025.pdf; *IOSCO Forms Task Force on OTC Derivatives Regulation*, CPIFINANCIAL, Oct. 26, 2010, http://www.cpifinancial.net/V2/fa.aspx?v=0&aid=662&sec=Investment%20 Banking.

290. *Proposal for a Regulation on OTC derivatives, Central Counterparties and Trade Repositories*, EUROPEAN COMM'N, 3 (2010), http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf.

291. *New Regulation of Derivatives in Japan*, FIN. SERVS. AGENCY GOV'T OF JAPAN, 2 (2010), http://www.cftc.gov/ucm/groups/public/@aboutcftc/documents/file/gmac_100510_fsag.pdf.

292. CFTC has prepared a detailed chart comparing Title VII of the Dodd-Frank Act to international legislation. *See generally*, *Derivatives Reform: Comparison of Title VII of the Dodd-Frank Act to International Legislation*, U.S. COMMODITY FUTURES TRADING COMM., (2010), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/gmac_100510-cftc2.pdf.

293. In fact, many important financial products, such as interest-rate swaps originated in the OTC markets and "if mid-twentieth century regulation had precluded the over-the-counter trading of derivatives, many important financial products would not have developed." Duffie, *supra* note 95.

Comment and Casenotes